Petition

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NO.

in the
Supreme Court
of the
United States

October Term, 1981

JOE T. BOYNTON AND HELEN J. BOYNTON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO
THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

PETITION

Robert O. Rogers
Rogers and Meisel
400 Royal Palm Way
Palm Beach, Florida 33480

QUESTION PRESENTED FOR REVIEW

1. Whether substantial economic effect, or economic reality, can be determined by an objective standard to the exclusion of all relevant facts and circumstances.

LIST OF THE PARTIES

The caption in this case contains the names of all parties.

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OPINIONS BELOW

The opinion of the United States Tax Court is reported at 72 TC 1147 and the opinion of the United States Court of Appeals for the Fifth Circuit is reported at ____ F.2d ____ (1981). These are appended hereto as appendices A and B respectively.

GROUNDS FOR JURISDICTION

The decision sought to be reviewed in this case was entered by the Court of Appeals for the Fifth Circuit on July 9, 1981. A timely motion for rehearing was filed on July 22, 1981, and denied by order entered on August 24, 1981. A copy of the order denying rehearing is included as Appendix C. The statutory provision conferring jurisdiction on this Court to review the judgment and court decree in question is 28 U.S.C. §1254(1).

THE STATUTES AND REGULATIONS INVOLVED

Sections 704(a) and (b) of the Internal Revenue Code of 1954, as of the year ending December 31, 1974, and as presently revised, promulgated thereunder as set forth in Appendix D to the Petition.

NO.

in the Supreme Court of the United States

October Term, 1981

JOE T. BOYNTON AND HELEN J. BOYNTON
Petitioners-Appellants,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

PETITION FOR WRIT OF CERTIORARI FROM THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

To the Chief of Justice and the Associate Justices of the Supreme Court of the United States:

Your Petitioners, Joe T. Boynton and Helen J. Boynton, hereby petition for a writ of certiorari to review the decision of the United States Court of Appeals for the Fifth Circuit holding that the allocation of losses to the Petitioners by partnership agreement lack economic effect.

STATEMENT OF THE CASE

In February, 1974, Joe T. Boynton, herein referred to individually as Petitioner, and Robert S. Plimpton, formed a partnership in order to purchase and operate a citrus grove on 1,922.37 acres of land located in Palm Beach County, Florida. Plimpton previously had contracted to acquire the grove for $3,075,685.00, plus certain expenses and commission, but did not have the financial ability to obtain institutional financing and close the transaction. Accordingly, Petitioner, who had the financial ability, agreed to obtain institutional financing for the acquisition in return for an equal interest in the partnership. At the time the partnership was formed it was contemplated that any funds needed by the partnership in excess of the institutional financing would be contributed equally by each partner.

The partnership did not generate sufficient profits or cash flow to cover its operating expenses and debt service. Plimpton could not honor his agreement to contribute equally to the partnership because of financial difficulties in his other business endeavors, which were believed to be of a permanent and continuing nature. Because of his personal liability on the initial debt financing, Petitioner agreed to supply the additional capital needed by the partnership. By reason of this change in the economic relationship between Plimpton and the Petitioner and their belief that Petitioner would bear the economic detriment of such losses, the parties agreed to allocate all partnership losses to Petitioner. However, because Petitioner wanted to preserve the possibility of recovering his losses in the event of a change in the financial position of Plimpton or the partnership, the funds advanced by the Petitioner were

characterized as loans. In this regard, the institutional loans received by the partnership were also viewed by the parties as cash contributions by the Petitioner since the institutional lenders would look to the Petitioner for repayment.

During 1974, Petitioner provided the partnership with $123,474.81 in cash while Plimpton's contributions were nominal in amount. As per the partnership agreement, Petitioner was allocated partnership losses for the year 1974 of $732,592.00. This one year disparity between the cash losses and tax losses was attributable to borrowed funds, and was temporary. As was found by the Tax Court, Petitioner's cash and tax losses were identical over the life of the partnership.

Section 704(a) of the Internal Revenue Code of 1954 provides that a partner's distributive share of income, gain, loss, deduction or credit for federal income tax purposes shall be determined by the partnership agreement. The only limitation to this permitted flexibility is that the allocation have business purpose and substantial economic effect or reality. The issue in this case is whether economic effect is to be determined from all facts and circumstances. The Courts below held that economic effect was to be determined solely by reference to book capital accounts, to the exclusion of other evidence showing that the losses for tax purposes were allocated to the person who would probably bear the detriment of those losses.

It is Petitioner's position that a special allocation of a partnership taxable loss, which was the product of arms length bargaining and possessed with business purpose, should be given effect for federal income tax

purposes if facts and circumstances show that the partner to whom such losses are allocated will likely suffer the economic detriment. This is based on legislative history where Congress specifically stated its intention to grant partners flexibility and the language of the Code allowing a division by partnership agreement, subject only to the requirement that such allocation have substantial economic effect or reality and business purpose, i.e. is not for the principal purpose of avoiding tax.*

The Court of Appeals concluded, as did the Tax Court below, that the allocation in this case lacked economic reality. This finding was based on the conclusion that economic effect is to be determined solely by reference to book entries and not the total facts and circumstances present in each case.

BASIS FOR FEDERAL JURISDICTION IN THE COURT OF FIRST INSTANCE

This proceeding was initiated by a Petition to the United States Tax Court seeking a redetermination of a deficiency in income tax as determined by the Commissioner of Internal Revenue. The Tax Court had jurisdiction under 26 U.S.C. §6214 and the Court of Appeals had jurisdiction to review the decision of the Tax Court under 26 U.S.C. §7482.

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*The governing Code provision for the year before the Court used the "tax avoidance" standard, which was modified to the present "lack of economic effect" standard. It is Petitioner's position that both are subject to an all facts and circumstance test.

ARGUMENT AMPLIFYING THE REASONS RELIED ON FOR THE ALLOWANCE OF THE WRIT

It is submitted that the writ should be allowed because the Court of Appeals decided an important question of Federal law in a way that is in conflict with the applicable decisions of this Court in that it determined "economic effect" and "business purpose" by an objective standard as opposed to an "all facts and circumstances test".*

More specifically, it is clear that whether an allocation has economic effect is dependent on all of the facts and circumstances. The decision on this fact must be based ultimately on the application of the fact-finding tribunal's experience with the mainsprings of human contact to the totality of the facts of each case. In determining what standard is applicable in making similar factual determinations, this Court has consistently held that nothing else will suffice. Thus in *Helvering v. Clifford*, 309 U.S. 331 (1930), this Court concluded that the ownership of property for tax purposes should be determined from all facts and circumstances; in *Commissioner v. Culbertson*, 337 U.S. 733 (1949), it rejected an attempt to determine the validity of a partnership by objective standards in favor of an all

*The issue involved in this case is important to the revenue. Upon basis of information furnished, there are 7,148 partnership cases in docketed status with the Tax Court. While the same question is obviously not involved in all of these cases, it is clear that a definition of "economic effect" is critical to a proper analysis of allocation issues. It is also noted that this large number of partnership cases may have influenced the Tax Court to utilize an objective standard in order to expediently determine what is "economic effect".

facts and circumstances test, and in *Commissioner v. Duberstein*, 363 U.S. 278 (1960) it refused to follow the Commissioner's suggestion that a standard be adopted to determine whether an item was compensation or a gift, holding specifically that such must be based on all facts and circumstances.

Even more on point is *Frank Lyon Co. v. United States*, 435 U.S. 561 (1978). In that case, this Court was specifically concerned with economic substance. It stated:

> "Where . . . there is a . . . transaction with economic substance which is compelled or encouraged by business or regulatory realities, is imbued with tax independent considerations, and is not shaped solely by tax avoidance features that have meaningless labels attached, the government should honor the allocation of rights and duties effectuated by the parties."

After making the foregoing statement, the Court held "What these attributes are in any particular case will necessarily depend upon its facts." In effect, in deciding whether there is economic substance, all facts and circumstances must be considered.

In summary, Section 704(a)* of the Internal Revenue Code permits partners to allocate partnership income, loss deductions and credits for federal income tax purposes between themselves by agreement. Congress specifically stated that this provision was designated to give partners flexibility in conducting their business activities in the

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*All section references are to the Internal Revenue Code of 1954, as amended.

partnership form, S. Rept. No. 1622, 83rd Cong., 2d Sess., p. 379-383 (1954), and the language of the statute supports such flexibility by permitting allocation by agreement. Under current law, and the law that is applicable to the taxable year in question, this flexibility is limited only by the requirement that a tax allocation have business purpose and economic reality. This is not disputed.

The only dispute relates to how a Court determines whether there is economic effect. Petitioner contends that such is to be determined by a "all facts and circumstances" test, and not by a standard that takes only one circumstance into consideration. The evil of the Court's application of an objective standard is readily apparent from the facts in this case. Here, it was likely that Petitioner would bear the economic detriment of any losses. It was also possible that there could be an economic turnaround. In that event he wanted recovery. This is not wrong. The objective standard used by the Court would require that he surrender all possibility of recovery to obtain the tax losses. That is not flexibility.

CONCLUSION

Petition for Writ of Certiorari should be granted.

Respectfully submitted

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October 22, 1981

Appendix A

JOE T. BOYNTON AND HELEN J. BOYNTON, PETITIONERS *v.* COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Docket No. 10526-77. Filed September 24, 1979.

T and P entered into an equal partnership agreement. As amended, the agreement continued to provide that profits were to be divided equally and losses were to be borne equally; however, it provided further that for purposes of Federal income tax returns 100 percent of the losses were to be allocated to T as his "distributive share." *Held*, T is entitled to deduct only one-half of the partnership's 1974 losses. *Kresser v. Commissioner*, 54 T.C. 1621 (1970), and *Holladay v. Commissioner*, 72 T.C. 571 (1979), followed.

Robert O. Rogers, for the petitioners.
Hans G. Tanzler III, for the respondent.

RAUM, *Judge:* The Commissioner determined deficiencies in petitioners' Federal income taxes as follows:

Year	*Deficiency*	*Year*	*Deficiency*
1971	$32,917	1973	$505
1972	1,567	1974	168,498

After concessions, the sole issue for decision is whether petitioner is entitled to deduct as his distributive share of partnership losses all of the losses incurred by the Palm Beach Ranch Groves partnership in the year 1974.

FINDINGS OF FACT

Some of the facts have been stipulated. The stipulation of facts and exhibits thereto are incorporated herein by this reference.

Petitioners Joe T. Boynton and Helen J. Boynton, husband and wife, resided in North Palm Beach, Fla., at the time their petition in this case was filed. They filed their joint Federal income tax return for each of the years 1971 through 1974 with the Internal Revenue Service Center, Chamblee, Ga. Petitioner Helen J. Boynton is a party to this case solely because she filed a joint return with her husband who will sometimes hereinafter be referred to as "petitioner."

On or about October 22, 1973, Robert S. Plimpton (Plimpton) entered into a contract to purchase approximately 1,922.37 acres of land in Palm Beach County, Fla., on which was situated a citrus grove, for a consideration of $1,600 per acre, in cash, for a total of $3,075,632.[1] In addition, as part of the consideration for the property, the buyer was to pay for the fruit on the trees, reimburse the seller for certain expenses, and pay the real estate commission due the broker in the amount of $400,000. Plimpton attempted to obtain financing to close the contract but was unsuccessful. He was advised by one lender that funds for the purchase could be obtained if a financially strong individual with

[1] The total acreage, the price per acre, and the total consideration were stipulated by the parties. There is an unexplained discrepancy of $160 between the stipulated total and the per-acre price multiplied by the number of acres. In another stipulation, the parties have referred to 1,922.27 acres of land, which, multiplied by the per-acre price, equals the stipulated total price.

an agricultural background joined in the transaction. Plimpton thereafter approached petitioner with a view to interesting him in participating in the citrus grove purchase. At that time, petitioner was very successful in sugarcane growing and other endeavors, and he had a substantial net worth. Petitioner agreed to join with Plimpton in the purchase.

During February 1974, Plimpton and petitioner organized a partnership known as Palm Beach Ranch Groves for the purpose of purchasing and operating the citrus grove. Pursuant to the undated, written partnership agreement between petitioner and Plimpton, all capital distributions, profits and losses were to be shared equally by the two partners. It was contemplated that the partnership would obtain the purchase money and initial working capital by partnership borrowing, and that each partner would contribute equally to the partnership any additional funds that might later be needed. Plimpton's contract to purchase the grove was assigned to the new partnership.

On February 28, 1974, utilizing the proceeds of two loans totaling $3,500,000, the grove was acquired by the partnership. Three million dollars of the borrowed funds came from a first mortgage loan from the John Hancock Mutual Life Insurance Co. (John Hancock), and the remaining $500,000 was obtained by loan from the First National Bank & Trust Co. of Lake Worth (First National)[2] secured by a note due petitioner (as

[2]The bank is also referred to from time to time in the record herein as the "First Marine National Bank & Trust Company." The difference in name is unexplained.

trustee) in the amount of approximately $725,000. Petitioner, Plimpton, and their respective wives were all jointly and severally liable for repayment of these two loans. At the time of closing, $3,075,632 was paid for the land, $40,000 for the fruit, $85,500 for reimbursement of maintenance expenses, and $116,000 towards the broker's commission.[3] The remainder of the borrowed funds was to be used as working capital.

To obtain the $3,500,000 of initial debt financing, petitioners and the Plimptons submitted their personal financial statements to the respective lenders. In these statements, the respective net worths of the Plimptons and Boyntons were reported as follows:

Partner	*Net worth per John Hancock statement*	*Net worth per First National statement*
Plimpton	$922,900	$974,745
Boynton	5,353,507	7,353,507

The financial statements submitted by Plimpton to the two institutions were both dated October 10, 1973.[4] The principal assets included in the statements were a residence valued at $340,000; 6.7 acres of commercial land located in Jupiter, Fla., valued at $370,000 in one statement and $435,000 in the other (this land

[3]The partners' agreement to assume liability for the $400,000 broker's commission called for the payment of $116,000 at the closing, $95,000 on the first and second year thereafter, and $94,000 on the third year, with interest at the rate of 8 percent per annum on the remaining unpaid balance.

[4]A second financial statement submitted to the bank by the Plimptons, dated Jan. 31, 1975, showed a net worth of $1,524,971.

had been purchased 1 month earlier for approximately $225,000, of which $67,000 was paid in cash and the balance by a purchase money mortgage note due 1 year from closing); stock in Atlantic & Pacific Research, Inc.,[5] valued at $300,000 (the corporation had a book value on December 31, 1973, based on an unaudited financial statement, of approximately $20,000); a boat, antiques, paintings, and miscellaneous personal assets.

The financial statements submitted by petitioner were both dated January 16, 1974. The discrepancy between the net worths listed in the two statements results from the utilization of book value of approximately $200-$250 per acre to value land owned by three sugarcane and cattle corporations in which petitioners owned stock for purposes of determining the value of the stock reported in the John Hancock statement, whereas a more realistic figure of $1,500 per acre was used for purposes of valuing the stock in the First National statement.

In evaluating the partnership's application for the $3 million loan, John Hancock was particularly interested in whether the partners had sufficient cash flow to service the debt in years during which the grove might

[5]The Plimptons owned 650 shares of the 850 shares of outstanding stock of Atlantic & Pacific Research, Inc. The 1974 income tax return of that corporation describes Mr. Plimpton as its president and indicates that he devotes "full" time to its business. The remaining shares were owned by members of the Plimpton family. The corporation dealt in a product somewhat akin to a fertilizer, which was described as a "plant growth regulator" that "stimulates plants to increase the size and quality of fruit."

operate at a loss.[6] John Hancock would have made the loan to petitioner without Plimpton's participation, but the loan would have been denied if Plimpton had applied alone. The decision to grant the loan, however, was based on the combined balance sheets and income statements of Plimpton and petitioner.

The $500,000 First National loan similarly would not have been approved on the basis of Plimpton's financial statements alone, but it would have been made to petitioner without Plimpton's involvement. First National made no independent investigation of the assets included in Piimpton's financial statement; such an investigation would have been conducted if the bank were making a loan solely on the basis of Plimpton's credit worthiness. Because of petitioner's sizeable net worth, the bank would have looked to him first for repayment of the loan if the partnership could not make repayment. However, both the Plimptons and the Boyntons each executed a separate "Special Guaranty" in respect of this loan.

Shortly after the partnership commenced business in 1974, it exhausted its initial borrowed working capital, and an additional $150,000 was borrowed from the Production Credit Association for use in partnership operations. This loan was arranged by taking advantage of petitioner's prior contacts with that organization. The proceeds of the Production Credit Association loan also were quickly expended. Plimpton advised petitioner

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[6]The John Hancock official who investigated the loan stated in his loan report that the projected cash flow from operation of the grove would be insufficient to service the debt in the early years of the partnership.

that the partnership needed additional funds to meet current operating expenses, and petitioner began making contributions to the partnership on the assumption that Plimpton would put in his share.

In about June or July 1974, it became clear that the grove was not operating as profitably as had been projected. The grove was planted with approximately 800 acres of oranges and 800 acres of lemons. The lack of profitability was in large part due to poor results in lemon production. Both the yield of harvested lemons per tree and the quality of the harvested fruit were much lower than had been expected. Plimpton and petitioner discovered that other growers in Florida were experiencing similar problems with lemons. The problem appeared to be State-wide and of a "permanent" nature to the extent of the quantity and quality of the fruit produced. However, the profitability of the operation could be affected by an improvement in price structure. Moreover, one could not make a reliable projection beyond 1 or 2 years, and the closer it might be to 2 years the less trustworthy it would become. Plimpton revised his financial projections on the basis of the partnership's actual results with the lemon crop, and he concluded that there was no chance at least in the near future that the grove could produce sufficient revenues to repay the partnership indebtedness unless there were a large increase in the market price for lemons or oranges.

During these periods of time, petitioner became concerned with the fact that Plimpton was not contributing his share of the required capital. Plimpton advised petitioner that he had no financial resources and would not be able to come up with any money

within the foreseeable future. At that time, the business of Atlantic & Pacific Research, Inc., which was Plimpton's principal source of income, had taken a drastic downturn,[7] and Plimpton could not obtain an offer on the commercial real property located in Jupiter, Fla., which he anticipated selling for a quick profit. In fact, this property was facing foreclosure. In September 1974, the partnership was faced with a need for substantial contributions to meet an October interest payment owed John Hancock in the amount of $135,000.

Petitioner discussed the situation with Everett Nowlen (Nowlen), a certified public accountant who represented him and his business interests, as well as Plimpton and his business interests. He informed Nowlen of Plimpton's statement to him that Plimpton could not support his share of the partnership expenses. Subsequently, Nowlen had conversations with Plimpton concerning this subject. At that meeting, the financial projections for the grove were discussed, and Nowlen concluded that the partnership could not carry its obligations within the near future. He also concluded that Plimpton was not able to carry his part of the financial obligation and that his inability to do so would be of a "permanent" and continuing nature. On the basis of the information available to him regarding the groves, and the financial affairs of petitioner and Plimpton, Nowlen advised petitioner that it would be hopeless to expect Plimpton to cover his share of the investment; that petitioner would have to do it himself; and that

[7]Such downturn appears to have been caused in large part by an adverse ruling of the Environmental Protection Agency (EPA), but the business subsequently turned around when EPA changed its position.

the partnership agreement should be modified to reflect the fact that petitioner would be the sole supporter of the partnership for some period of time. The particular modification suggested by Nowlen was that petitioner be allocated the benefit of all (instead of one-half) of the partnership's losses for tax purposes.

On the basis of Nowlen's recommendations, the parties amended the partnership agreement on October 30, 1974. Such amendment provided that whenever one partner made advances in excess of the other partner, the amount of the excess advances would be treated as a loan to the partnership, which loan would have priority of repayment from the next cash distributions actually made. Only one partner at any given time could have a credit balance in his loan account. It was next provided that all of the tax losses of the partnership would be allocated to the partner with the credit balance in his loan account regardless of the amount of the credit balance. The allocation of losses was to affect the method of reporting losses (not profits) for income tax purposes, but not the allocation of economic profits and losses, nor the amounts of distributions in the event of dissolution or sale of the partnership property. For purposes other than income taxes, the preexisting equal division of profits and losses remained in effect. Relevant portions of the amendment to the partnership agreement are as follows:

WHEREAS, the partnership is in need of cash funds to meet its obligations; and

WHEREAS, Boynton is willing to supply such funds by way of loans to the partnership, but only if he

receives the benefit of all partnership losses, until such time as all funds have been returned; and

* * * * * * *

ARTICLE IV-1 PROFITS AND LOSSES

4.11 Except as otherwise provided for determining each partner's share of the partnership income and loss for purposes of the federal income tax, all profits and losses of the partnership shall be allocated equally between the two partners.

4.12 Notwithstanding the provisions of Section 4.11 hereof, the partners recognize that Boynton will be required to make cash available to the partnership from time to time until such time as it shows a positive cash flow; and that Boynton is the individual to whom the institutional lenders will look for a repayment of the partnership loans if they cannot be satisfied out of partnership funds.

Because of the foregoing, the allocation between them of profits and losses for tax purposes, but not for the purpose of determining their share of distributions (which shall be governed by Section 4.11 hereof), shall be as follows:

(a) The taxable income and/or loss of the partnership under the governing provisions of the Internal Revenue Code of 1954 shall be determined; then

(b) As long as there is a credit balance in either partner's loan account, all losses shall be allocated to such partner;

(c) Gains from the sale of any asset with respect to which the partnership has claimed depreciation, shall be allocated to the partner who received the tax benefit from such depreciation to the extent of the lesser of such depreciation or the amount of gain; and

(d) All other income, gains, profits, and for any year in which there is no balance in either partner's loan account as of the end of such year, losses, shall be allocated in accordance with the ratio for sharing profits and losses.

ARTICLE IV-2 CAPITAL AND LOANS

4.21 The partners may from time to time make advances to the partnership. To the extent such advances are equal, the amounts thereof shall be credited to each partner's capital account.

4.22 The amounts by which the total net advances made by one partner exceed the total net advances made by the other partner, shall be treated as loans to the partnership by the partner making such excess advances; and shall bear interest at the rate of nine (9%) percent per annum. Such interest shall be paid as funds are available.

ARTICLE IV-3 DISTRIBUTIONS

4.31 From time to time, the partnership shall distribute to its partners, in proportion to their interest in partnership profits and losses, all of its available cash. All such distributions shall be made to and among the partners and divided among them on the basis of their respective interests in the profits of the partnership,

and no cash distributions shall be made to any partner except in repayment of loans and/or interest thereon, unless a proportionate amount, according to their respective interests in the partnership profits, is distributed to the other partner.

* * * * * * *

4.33 No cash shall be considered available until all amounts advanced by a partner and treated as loans have been repaid; it being understood that all advances treated as loans and the interest thereon are to be repaid before any cash distributions are made to the other partner.

ARTICLE IV-4 ACCOUNTING

4.41 The partnership shall maintain a capital, loan, drawing, and income account for each partner.

4.42 The income account of each partner shall be debited or credited with such partner's share of the profits and losses allocated in the manner specified in section 4.11 hereof.

4.43 All advances by the partners to the partnership shall be treated in the manner specified in Article IV-2 hereof. All distributions to a partner shall be treated as repayments of a partner's loans to the extent thereof, and any excess shall be charged to such partner's drawing account.

4.44 The different allocations of profits and losses for tax purposes *shall not effect* (sic) [emphasis added]

or be considered as a part of the partnership accounting, the sole purpose of such differing treatment being to allocate losses for tax purposes to the person who will suffer such losses in the event the partnership does not later make sufficient income to meet its obligations.

Nowlen expected the partnership to sustain losses in 1974. His recommendation concerning the allocation of tax losses was predicated in large part on his belief that, given Plimpton's weak financial situation, petitioner would have to support the partnership without help from Plimpton at least in the immediate future and bear the risk of being called upon personally to repay the partnership loans. At the time the recommendation was made, Nowlen knew that Plimpton would report approximately $40,000 of income for the year 1974, and that petitioner had received or anticipated receiving at least several hundred thousand dollars of ordinary income in 1974.[8] Nowlen never recommended a change in the allocation of economic profits or losses to give petitioner a greater economic share of the partnership.

Plimpton and petitioner both thought the partnership amendment was fair for the reasons advanced by Nowlen.

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[8]Petitioner's adjusted gross income in the years 1971 through 1974 (excluding the net operating losses from the Palm Beach Ranch Grove partnership), was as follows:

Year	Adjusted gross income	Year	Adjusted gross income
1974	$675,153	1972	$142,288
1973	272,959	1971	110,765

Dividends from a closely held corporation controlled by petitioner accounted for $272,620 of the gross income reported in 1974. The

A reduction of Plimpton's economic interest in the partnership was not favored because the partnership desired to retain Plimpton's goodwill. Petitioner was aware of, and sought, the tax advantage that would arise in his favor under the modified partnership agreement. Petitioner would have continued making capital contributions to the partnership even without the inducement of the tax benefits; petitioner felt that he had no choice in the matter because of his personal liability for the partnership's obligations.

During the year 1974, petitioner's contributions to the partnership exceeded those made by Plimpton by $123,474.81. The excess contributions were reclassified as a loan consistent with the amended partnership agreement. Because of this $123,474.81 credit balance in petitioner's loan account, all of the ordinary loss of $730,592 reported by the Palm Beach Ranch Groves partnership in 1974 was allocated to petitioner.

After petitioner realized that the grove was not profitable and that he would be required to support the partnership for the foreseeable future, he caused the

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(Footnote 8 Continued)

maximum dividends reported by petitioners in any of the preceding 3 years from all sources was $5,682.

In contrast, the Plimptons reported adjusted gross income in the years 1971 through 1974 as follows:

Year	*Adjusted gross income*	*Year*	*Adjusted gross income*
1974	$ 44,773	1972	$41,220
1973	109,389	1971	44,179

commencement of efforts to sell the property. Such efforts were initiated as early as the fall of 1974. A bona fide offer for the property was not obtained until 1977. On March 8, 1977, the partnership sold the citrus grove, excluding the fruit on the trees, for $3,570,000. The citrus fruit, retained by the partnership, was placed in a citrus pool for sale. As a part of the sale contract, Plimpton was required to continue managing the grove on behalf of the purchaser for $1,900 per month. Plimpton believed that this requirement was detrimental to him. Before the sale was finally agreed to, petitioner had been concerned that Plimpton would not consent to the sale unless he received additional compensation for undertaking the management obligation. Accordingly, an understanding was reached whereby Plimpton would receive all of the proceeds from the citrus pool remaining after the partnership's liabilities, excluding partnership liabilities to petitioner, were satisfied. This amount was estimated to be $15,000 to $30,000. However, the citrus pool payments turned out to be much larger than expected, and $85,000 to $90,000 remained after satisfaction of the partnership liabilities (other than those owed to petitioner). Petitioner and Plimpton agreed to and did split this money evenly. No other funds were ever recovered by petitioner from the partnership.

From the commencement of the partnership through 1977, petitioner made unmatched cash contributions to the partnership aggregating $1,121,066.16.[9] During the same period, the partnership incurred losses in the amount of $1,191,186.78, all of which were allocated to

[9]Petitioner's excess cash contribution in years after 1974 were not classified as loans, but were treated as contributions to partnership capital for accounting purposes.

petitioner. By the end of 1978, petitioner's tax losses and cash losses were exactly equal.

Petitioner was advised by his attorney that he had a right of contribution under Florida law against Plimpton in respect of the loans he made to the partnership. Petitioner has never relinguished this right pursuant to an agreement with Plimpton. Plimpton informed petitioner more than once that he felt himself to be under no obligation to repay any of the partnership's losses. Because of Plimpton's feelings in this regard and petitioner's belief that Plimpton lacked sufficient assets to pay, petitioner has made no efforts to enforce his right of contribution.

In his 1974 return, petitioner deducted $732,592 as his distributive share of the net losses of the Palm Beach Ranch Groves partnership for the year 1974. Petitioners claimed a net operating loss for the year 1974 in the amount of $59,366.02,[10] which was carried back to prior years. Tentative carryback refunds were granted for the years 1971 and 1972 in the amounts of $32,917 and $1,567, respectively. The Commissioner determined that petitioner's distributive share of the 1974 loss of the Palm Beach Ranch Groves partnership was only half of the partnership's loss, or $366,296, rather than the full $732,592 claimed on the 1974 return. He further determined that the 1971 and 1972 tentative carryback refunds should be "recaptured" in full since

[10]Petitioners have conceded that the Commissioner correctly increased petitioners' 1974 taxable income by $4,396.98. Accordingly, the $63,763 net operating loss deduction claimed in petitioners' application for tentative carryback refund has been reduced to $59,366.02 for purposes of this case.

the adjustment to petitioner's 1974 distributive share of the partnership loss eliminated the net operating loss claimed for that year.

OPINION

The only issue for decision is whether the 1974 amendment to the partnership agreement, purporting to allocate all of the tax losses of the Palm Beach Ranch Groves partnership to petitioner, was a bona fide allocation of losses within the meaning of section 704, I.R.C. 1954. Stated differently, we must determine whether the amended partnership agreement in fact increased petitioner's distributive share of the partnership's losses from 50 percent to 100 percent. We think that it did not, and hold that petitioners may not deduct more than half of the partnership losses suffered in 1974.

Partners are required by section 702(a)[11] to report their distributive share[s]" of partnership "taxable income or loss," section 702(a)(9), as well as their distributive share of specified items enumerated in sections 702(a)(1)-702(a)(8). The partners enjoy wide latitude under

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[11]SEC. 702. INCOME AND CREDITS OF PARTNER.

(a) GENERAL RULE.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—

(1) gains and losses from sales or exchanges of capital assets held for not more than 6 months,

(2) gains and losses from sales or exchanges of capital assets held for more than 6 months,

section 704[12] to fix their respective distributive shares in the partnership agreement, but this discretion is not unlimited. For example, a partnership agreement that purports to fix distributive shares of *items* enumnerated in section 702(a)(1) through (8) by making a "special

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(Footnote 11 Continued)

(3) gains and losses from sales or exchanges of property described in section 1231 * * *

(4) charitable contributions * * *

(5) dividends with respect to which there is provided an exclusion under section 116, or a deduction under part VIII of subchapter B.

(6) taxes, described in section 901, paid or accrued to foreign countries and to possessions of the United States,

(7) partially tax-exempt interest on obligations of the United States * * *

(8) other items of income, gain, loss, deduction, or credit, to the extent provided by regulations prescribed by the Secretary or his delegate, and

(9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

Sec. 702(a) has been amended for years subsequent to the years at issue by the Tax Reform Act of 1976, Pub.L.94-455, 90 Stat. 1520.

[12]SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) EFFECT OF PARTNERSHIP AGREEMENT.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

allocation" of those items to certain partners will be ineffective for tax purposes if the principal purpose of the allocation is the avoidance or evasion of tax. (See sec. 704(b)(2).) The Commissioner has conceded that as a matter of statutory construction section 704(b)(2) is inapplicable to this case which involves an attempted allocation overall or "bottom line" losses described in section 702(a)(9) rather than an allocation of any of the "items" described in section 702(a)(1)-702(a)(8). See generally *Holladay v. Commissioner*, 72 T.C. 571, 586-587 (1979), for the rationale of the Commissioner's concession in respect of the inapplicability of section 704(b)(2) to

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(Footnote 12 Continued)

(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO.—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9) for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

Sec. 704 was amended for the taxable years beginning after Dec. 31, 1975, by sec. 213(d). Tax Reform Act of 1976, Publ L. 94-455, 90 Stat. 1548. The Senate Finance Committee report indicates that the amendment was not intended to permit any inference to be drawn as to the propriety or impropriety of allocations of partnership income or deductions under prior law. S.Rept. 94-938, pp. 100-101 (1976), 1976-3 C.B. (Vol. 3) 49, 138-139. See *Holladay v. Commissioner*, 72 T.C. 571, 586 n. 7 (1979). However, it does seem that the amendment would be applicable to any partnership losses which petitioner may have claimed for 1976 and 1977.

allocations of section 702(a)(9) "bottom line" taxable income or loss.

However, the power of the partners to fix their *overall* "distributive" shares is subject to another and more sweeping limitation, namely, that the purported allocations of income and losses nominally made in the partnership agreement must be bona fide in the sense that they are genuinely in accord with the actual division of profits and losses inter sese which the partners have in fact agreed upon among themselves. Thus, if provisions of the partnership agreement itself effectively spell out how the profits are *required* to be divided and how the losses are *required* to be borne, the "distributive" shares of the partners will be determined in accordance with such provisions, rather than by an artificial label in the agreement which characterizes as "distributive" an entirely different allocation of profits and losses, and which has meaning in terms of the partnership agreement only in respect of the partners' liability to the Internal Revenue Service. This does not mean that the partners are precluded from fixing their distributive shares in any manner they choose. What it does mean is that in construing the partnership agreement, the formula which *they* select for actually dividing profits and apportioning losses among themselves will be determinative of their "distributive" shares, rather than a different formula arbitrarily included in the agreement which is to be applicable only for the purpose of filing income tax returns, and which is to have no legal consequences in respect of their rights against one another. In short, where one provision of the agreement which purports to characterize as "distributive" a certain division of profits and losses is contradicted by another provision which legally fixes the rights of

the partners inter sese, it is the latter provision, rather than the former, which establishes the "distributive" shares of the partners within the meaning of the statute. The overriding principle is sometimes referred to as the doctrine of "substance over form," or is alternatively described as the "economic substance" text. See, e.g., 1 A. Willis, Partnership Taxation, sec. 25.11, pp. 316-319 (1976).

This approach in the interpretation of the meaning of the statutory words "distributive share" first appeared in *Kresser v. Commissioner*, 54 T.C. 1621 (1970). The vitality of the doctrine in cases involving allocations of section 702(a)(9) taxable income or loss has been recently reaffirmed in *Holladay v. Commissioner, supra.*[13] Under *Kresser* and *Holladay*, a partnership agreement that purports to set forth distributive shares of bottom line income or loss will not be respected for tax purposes unless the distributive share provisions of the agreement constitute a bona fide allocation of income or loss between the partners, rather than an allocation having no consequences of substance in the partnership agreement other than the desired tax consequences. *Kresser v. Commissioner, supra* at 1632. "[F]or allocations of partnership bottom line income or loss to be bona fide for Federal tax purposes the allocations must accurately reflect the economic basis upon which the partners have agreed to share the profits and losses." *Holladay v. Commissioner, supra* at 587. *Kresser* and *Holladay*

[13]For another recent case applying the substance over form or economic substance test to disallow an attempt to allocate 100 percent of a partnership's bottom line tax loss to certain partners, see *Sellers v. Commissioner*, 36 T.C.M. 305, 317-319, 46 P-H Memo T.C. par. 77,070 (1977), affd. on other issues 592 F.2d 227 (4th Cir. 1979).

establish that the term "distributive share" as used in section 702(a)(9) refers to each partner's agreed-upon share of the economic profits and losses, not to the basis upon which the partners might agree to report income or claim losses on their individual returns.[14] We think that this case is not fairly distinguishable from *Kresser* and *Holladay*.

An examination of the amendment to the partnership agreement reveals that the allocation of 100 percent of the tax losses to petitioner in no way changed petitioner's economic stake in the venture, and did not reflect the economic basis upon which the partners agreed to share profits and losses. Article 4.11 of the amendment states that all profits and losses shall be allocated equally between the two partners, in the same manner as before the amendment, except for purposes of the Federal income tax. Article 4.12 sets forth the mechanism for the allocation of tax losses whereby any partner who makes advances to the partnership that are not matched by the other partner (such excess advances are deemed to be "loans") shall be entitled to the tax losses of the partnership (not the taxable income) regardless of the amount of that partner's unmatched advances. Articles

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[14] See *Sellers v. Commissioner*, 36 T.C.M. at 318, 46 P-H Memo T.C. par. 77,070 at p. 77-320, where it was stated:

"The documents to which petitioner directs our attention establish beyond serious question that the partners agreed that John Sellers would claim the taxable losses of the partnership for 1964 through 1966 on his individual returns. However, it is the basis on which partners agree to share the economic profits and bear the economic losses of the partnership that determines their distributive shares of taxable income and loss, not the basis on which they might agree to report income or claim losses on their individual returns."

4.12 and 4.44 expressly provide that the different allocation of losses for tax purposes has no effect on the partners' respective shares of partnership distributions or on partnership accounting; the equal division of profits and losses under article 4.11 controls for purposes other than taxes. Nothing in the partnership agreement relieves Plimpton of his obligation under article 4.11 to bear half of the economic losses that might be realized by the partnership upon sale of the grove or liquidation of the partnership. Florida partnership law gives petitioner a right of contribution against Plimpton whereby Plimpton could be compelled after liquidation of the partnership to pay over sufficient funds to equalize the economic losses suffered by each partner.[15] The partnership agreement is silent as to the rights of the partners against each other if the losses sustained by each of the partners are not equal after dissolution, and the law of Florida in this respect must be deemed a part of the partnership agreement. Sec. 1.761-1(c), Income Tax Regs.

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[15]Fla. Stat. Ann. sec. 620.645(1) (West 1977)(identical to sec. 18 of the Uniform Partnership Act) states that subject to any agreement between the partners, each partner shall be repaid his contributions to the partnership, whether by way of capital or advances, and that each partner must contribute to the partnership's losses according to his share in the profits. Fla. Stat. Ann. sec. 620.755(1)-(4) (West 1977)(identical to sec. 40 of the Uniform Partnership Act) requires that if the partnership assets are insufficient upon dissolution of the partnership, each partner must contribute his share under sec. 620.645(1) of the amount necessary to satisfy the partnership liabilities, including those owing to creditors other than partners and to partners for advances and capital. Thus, these statutes authorize peitioner to recover from Plimpton half of any unpaid partnership liabilities, including petitioner's advances to the partnership, and half of any other losses sustained by the partnership. See generally A. Bromberg, Crane and Bromberg on Partnership 367, 369-370, 507 (1968).

Petitioner was advised of this right of contribution by his attorney.

In short, the amended partnership agreement attempts to allocate 100 percent of the partnership's tax losses to petitioner while at the same time allocating to petitioner only 50 percent of the economic losses. Such a tax allocation is impermissible under *Kresser* and *Holladay*. The distributive shares of the tax losses must be determined in accordance with the partners' agreement to share economic profits and losses equally. We conclude that petitioner's distributive share of the 1974 partnership tax loss was 50 percent.

Petitioner attempts to avoid the result dictated by *Kresser*, *Holladay*, and similar cases by arguing that the "real agreement" between the partners in light of the economic realities at the time of the amendment to the partnership agreement was that petitioner would bear 100 percent of the losses. The short answer is that we do not believe that there was any such "real agreement" between petitioner and Plimpton. The amended partnership agreement was executed on October 30, 1974, in the light of Plimpton's financial situation at that time and the expectation that petitioner alone would continue at least during the immediately foreseeable future[16] to make advances to the enterprise. Yet, the

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[16]It is true that the word "permanent" is used in the testimony from time to time, not only with respect to Plimpton's financial circumstances but also with respect to the prospects of profitable operation of the citrus grove and the possibility of recouping losses in the future. However, we are satisfied that such conditions were not permanent in any literal sense, and were not inconsistent with a possible improvement in the economic climate from the recession laws of 1974 and 1975 that would materially change the

provisions of the agreement are unmistakably clear. While they set forth a scheme of priorities in respect of repayment of the advances, they leave clear beyond any reasonable doubt that any possible profits are to be divided equally and that both partners are to be equally accountable for losses. We do not believe that there was any contemporaneous oral understanding that these provisions do not mean what they so plainly declare. Nor do we believe that there was any subsequent modification, notwithstanding Plimpton's unilateral statement that he did not regard himself bound.[17] So far as this record shows, petitioner never released Plimpton from his obligations.

Harrell v. Commissioner, 37 T.C.M. 911, 916-917, 47 P-H Memo T.C. par. 78,211 (1978), relied upon by petitioner, is distinguishable. In *Harrell*, a partnership agreement called for an equal division of losses between the two partners and for equal capital contributions by each. One partner contributed no capital, however, and the agreement was silent as to the effect of that partner's delinquency on the loss-sharing ratio. We inferred an

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(Footnote 16 Continued)

picture. The record certainly contains no satisfying proof of Plimpton's insolvency, and we were impressed with his business resiliency. Hence, we have concluded that the words "immediately foreseeable future" more accurately characterize the situation than does the word "permanent."

[17]Any such possible subsequent modification would, of course, be subject to the requirement in sec. 761(c) that it be "made prior to, or at, the time prescribed by law for the filing of the partnership return for the taxable year (not including extensions)" and that it be "agreed to by *all* the partners, or * * * adopted in such other manner as may be provided by the partnership agreement." (Emphasis supplied.)

intention to allocate losses to the party who made all of the capital contributions. In contrast, the amended partnership agreement in this case was specifically intended to reflect the understanding of the partners concerning Plimpton's inability at that time to contribute his share of the needed funds to the partnership, and the amendment expressly provides for an equal sharing of economic profits and losses. We cannot disregard the intention of the parties so clearly expressed in the amendment.

Petitioner emphasizes the fact that up to the time of the hearing he had not recovered any portion of the losses from Plimpton. Superficially, this circumstance is very appealing but reflection will demonstrate that there is no merit to the point. In the first place, to the extent that petitioner is now out-of-pocket in respect of his advances he remains entitled, either as a creditor or as a partner, to be reimbursed by Plimpton for the latter's allocable one-half share. And the only matter before us in this case is whether petitioner has a valid claim to deduct all rather than one-half of the partnership's $730,592 loss for 1974. Although, as a matter of partnership tax law, his deductible loss for 1974 is limited to his distributive one-half share of that loss, this does not mean that he will not obtain a tax benefit in respect of the other one-half if he does not ultimately obtain reimbursement from Plimpton. The matter may be primarily one of timing.

We know of no basis upon which Plimpton can be relieved of his liability to make petitioner whole in respect of that one-half of the loss, and no such basis has been suggested to us on behalf of petitioner. The only point that is made is petitioner's conclusion that it

would be futile to pursue his rights against Plimpton in view of the latter's stated, but apparently thoroughly unsound, position that he is not obligated to petitioner. The record does not establish that Plimpton is a deadbeat, or that one would have to be an "incorrigible optimist" (*White Dental Co. v. United States*, 274 U.S. 398, 403 (1927)) to press one's claim against him. Nor is there even any evidence that Plimpton is insolvent. To the contrary, although he suffered financial reverses, there is no indication that he does not have significant assets, and the record affirmatively shows that there has been a turn-around in the fortunes of his corporation (Atlantic & Pacific Research, Inc.).[18] If and when petitioner's

[18]Plimpton's net worth statements as of Oct. 10, 1973, and Jan. 31, 1975, showed an excess of assets over liabilities in amounts of over $900,000 and over $1,500,000, respectively. Although his net worth may have been overstated therein, and although he thereafter sustained financial reverses with respect to his corporation and his real property in Jupiter, the record fails to show how much he may have realized on the Jupiter property or that the stock in his corporation became worthless. Indeed, the problems relating to his corporation appear to have been caused by an EPA ruling, which was subsequently reversed, and the record shows that the corporation has since acquired valuable contract rights in respect of a certain new product. Moreover, there is no suggestion that Plimpton doesn't continue to reside in a home owned by him which had a stated value of $340,000 in 1973 and 1975 (subject to a mortgage of some $49,000 in 1975), and from all that appears, he is still projecting the image of a wealthy man. A further indication of his lifestyle is reflected in his income tax returns which show charitable contributions in the amounts of $9,242 for 1974, $3,313 for 1975, and $24,922 for 1977. This is hardly the picture of an impecunious person. We have already noted (n. 16 *supra*) our impression as to his resiliency in business affairs, and we cannot conclude in the face of these circumstances that petitioner's claim against him is hopeless. It would certainly be a matter of prudence for someone in petitioner's position to take appropriate steps to preserve his rights against Plimpton.

rights against Plimpton should become worthless, either in whole or in part, an appropriate deduction will be available to him at that time. Meanwhile, there is no basis for allowing petitioner a deduction in respect of the one-half partnership's 1974 loss properly allocable to Plimpton.

Decision will be entered for the respondent.

Appendix B

Joe T. BOYNTON and Helen J. Boynton,
Petitioners-Appellants,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 80-5069.

United States Court of Appeals,
Fifth Circuit.
Unit B

July 9, 1981.

Taxpayer petitioned for a redetermination of federal income tax deficiencies assessed against him by the Commissioner of Internal Revenue for calendar years 1971 through 1974. The United States Tax Court, 72 T.C. 1147, found for the Commissioner, and taxpayer appealed. The Court of Appeals, Frank M. Johnson, Jr., Circuit Judge, held that amendment to partnership agreement providing that, whenever one partner make a greater contribution to the partnership than the other, the excess would be treated as a loan to the partnership and the partner making the excess contribution would be entitled to allocation of all of the federal tax losses of the partnership did not constitute a bona fide allocation of losses, as the overall distribution of profits and losses remained unchanged under the amended agreement, and, therefore, taxpayer partner, who made excess contributions to the partnership was not entitled to claim more than 50% of the partnership's losses on his income tax returns.

Affirmed.

1. Internal Revenue —604

Only partner who actually incurs a loss will be allowed an income tax deduction for such loss.

2. Internal Revenue —604

If partner had contributed all of the partnership capital, then allocation of all of the partnership's taxable losses to him as the sole contributing partner would have been proper to reflect the fact that he bore the entire economic burden of any loss. 26 U.S.C.A. §704.

3. Internal Revenue —236

Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized.

4. Internal Revenue —604

Amendment to partnership agreement providing that, whenever one partner make a greater contribution to the partnership than the other, the excess would be treated as a loan to the partnership and the partner making the excess contribution would be entitled to allocation of all of the federal tax losses of the partnership did not constitute a bona fide allocation of losses, as the overall distribution of profits and losses remained unchanged under the amended agreement, and, therefore, partner who made excess contributions to the partnership was not entitled to claim more than 50% of the

partnership's losses on his income tax returns. 26 U.S.C.A. §§702(a)(9), 704, 704(a), (b)(2).

Appeal From the Tax Court of the United States.

Before HILL, and FRANK M. JOHNSON, Jr., Circuit Judges, and SCOTT*, District Judge.

FRANK M. JOHNSON, Jr., Circuit Judge:

Joe T. Boynton[1] petitioned the United States Tax Court for a redetermination of federal income tax deficiencies totalling $203,487 assessed against him by the Commissioner of Internal Revenue [Commissioner] for calendar years 1971 through 1974.[2] The Tax Court, 72 T.C. 1147, found for the Commissioner and we consider Boynton's appeal under 26 U.S. C.A. §7482. This appeal and that of *Holladay v. Commissioner*, slip op. p. 8853, ____ F.2d (5th Cir. 1981), No. 80-5274, (consolidated for oral argument and decided the same day) both involve the propriety of allocating all of the losses sustained by a partnership to one partner. Because we conclude that these allocations lacked substantial economic effect, we affirm.

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*District Judge of the Middle District of Florida, sitting by designation.

[1]Mrs. Helen J. Boynton is a party solely because she filed joint returns with her husband for the years at issue.

[2]The only tax year at issue is 1974 as the deficiencies assessed for tax years 1971-73 are related to the 1974 return. The tax years 1971 and 1972 are involved solely because Boynton claimed a net operating loss carryback from 1974; the 1973 tax year utilized income averaging based on the revised 1971 and 1972 figures.

I. Facts

The facts are substantially undisputed. In February 1974, Boynton formed the Palm Beach Ranch Groves partnership in order to purchase and operate a citrus grove. Plimpton, who was to operate the grove, had a pre-existing agreement to purchase the 1,922.37-acre citrus grove located in Palm Beach County, Florida, at $1,600 an acre for a total price of approximately $3,075,635; he also agreed to reimburse the seller for expenses, pay for the fruit on the trees and pay a brokerage commission. However, Plimpton was unable to obtain institutional financing for this project without the participation of a financially strong individual such as Boynton who also had an agricultural background. Plimpton's contract for the purchase of the grove was assigned to the partnership. They agreed that the partnership would borrow the purchase money and initial working capital and thereafter each partner would equally contribute any additional funds that might be required to operate the grove.

They were able to borrow $3,000,000 from the John Hancock Mutual Life Insurance Company [John Hancock] and $500,000 from the First National Bank & Trust Company of Lake Worth [First National]. As security Boynton, Plimpton and their wives had to submit personal financial statements and agree to be jointly and severally liable for the repayment of the loans;[3] additionally Boynton also submitted a personal note worth approximately $725,000 as security for the

[3]The Boyntons reported $5,353,507 as their net worth for the John Hancock Loan and $7,353,507 for the First National loan; the Plimptons reported $922,900 as their net worth on the first loan and $7,353,507 on the second loan.

First National loan. When the purchase was closed, the partnership had paid $3,075,632 for the land, $40,000 for the fruit on the trees, $88,500 for reimbursement of maintenance expenses, and $116,000 for the broker's commission with the balance of the $3,500,000 being used for working capital. This working capital was soon exhausted and the partners, utilizing one of Boynton's contacts, borrowed an additional $150,000 from the Production Credit Association. These funds were also quickly exhausted and Plimpton informed Boynton that more funds were needed to meet the grove's operating expenses. Boynton began making contributions to the partnership on the assumption that Plimpton would make matching contributions.

It became clear during June and July 1974 that the grove was not operating as profitably as projected mainly because the yield and the quality of the lemon crop were much poorer than expected.[4] Moreover Boynton became concerned with Plimpton's failure to contribute his share of the capital as required by the partnership agreement. Plimpton claimed he could not make his contributions within the near future because he had no financial resources to draw upon. Apparently one of Plimpton's businesses had been shut down by an Environmental Protection Agency order and one of his commercial properties worth approximately $370,000 was being foreclosed. The partnership needed at least $135,000 in order to meet the October interest payment to John Hancock.

Boynton discussed the situation with their accountant, Everett Nowlen, who concluded that

[4]The grove was planted with 800 acres of lemons and 800 acres of oranges. Apparently lemons do not grow well in Florida.

Plimpton's inability to carry his financial obligation was of a permanent or continuing nature; the accountant advised Boynton that the partnership agreement should be modified to reflect the fact that Boynton would be the sole supporter of the partnership for a period of time. On October 30, 1974, the partnership agreement was amended as follows: (1) whenever a partner made a greater contribution than the other, the amount of excess advances would be treated as a loan to the partnership (with a priority right of repayment from subsequent cash distributions); (2) only one partner at a time could have a credit balance in his loan account; (3) all of the federal tax losses of the partnership would be allocated to the partner with the credit balance in his loan account regardless of the actual amount in the credit balance; (4) the allocation of losses only affected the method of reporting losses (but not profits) for income tax purposes since for purposes other than federal income taxes, the prior provisions that required an equal division of profits and losses remained in effect;[5] and (5) after all of the excess advances were repaid with interest, the original agreement was again in effect. *See* Appendix, Amended Partnership Agreement. Nowlen did not recommend and Boynton did not request a change in the allocation of overall economic profits or losses to give Boynton a greater economic share of the partnership to reflect his additional contributions as Boynton did not want to surrender his right of recoupment against Plimpton for the unmatched contributions should his economic situation turn around.

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[5]This loss allocation did not affect the overall allocation of economic profits and losses or the amount of distributions available if a sale of the grove or dissolution of the partnership occurred.

Both partners were satisfied that the modifications to the partnership agreement were fair under the circumstances. Boynton was aware of the tax benefits that the new loss allocation provision would provide him and he actively sought this tax advantage. Boynton would have continued to make monetary contributions to the partnership even without the tax incentive of the new loss allocation because of his personal liability for the partnership's obligations. During 1974, Boynton's capital contributions, which exceeded Plimpton's by $123,474.81, were reclassified as loans thus giving Boynton a credit balance in his loan account. Because of this credit balance, *all* of the partnership's taxable losses of $730,592 were allocated to Boynton. On his 1974 return Boynton deducted $732,592 as his distributive share of the partnership's net losses; the Commissioner disagreed that Boynton could claim 100% of the partnership's losses and allowed Boynton only 50% of the partnership's losses or $366,296 as his distributive share. Boynton had also claimed that $59,366.02 was the net operating loss for 1974 and carried that loss back to 1971 and 1972 for tentative refunds of $32,917 and $1,567. But because the redetermination of Boynton's distributive share eliminated the net operating loss for 1974, these tentative refunds had to be recaptured by the IRS. The Commissioner assessed deficiencies of $32,917 (1971), $1,567 (1972), $505 (1973) and $168,498 (1974) for a total of $203.487.

Boynton tried to sell the grove as early as the fall of 1974 but a bona fide offer of $3,570,000 for the grove (excluding the fruit) was not received until 1977. The fruit on the trees was put in a citrus pool for sale. Plimpton agreed to continue managing the grove for $1,900 per month but only if he received as additional

compensation 100% of the profits from the citrus pool. The profits from the citrus pool were estimated at $15,000 to $30,000 but were much larger than expected. After the partnership liabilities were satisfied, excluding the money owned to Boynton, $85,000 to $90,000 remained from the citrus pool sale, which money was equally divided between Boynton and Plimpton. These funds were the only funds ever recovered by Boynton from the partnership. When the partnership was eventually terminated in 1978, Boynton's economic and tax losses were identical.[6]

II. Interpretation of Boynton's Loss Allocation Under IRC §704(a)

The sole issue before the Tax Court was whether the partnership's amended loss allocation provision under which Boynton claimed 100% of the partnership's 1974 taxable losses was a bona fide allocation of losses within the meaning of Section 704 of the Internal Revenue Code of 1954 [IRC], as amended, 26 U.S.C.A. §704.[7] The Tax Court ruled against Boynton by finding that, since

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[6]After 1974 all excess advances were classified as contributions, *not* loans. The Tax Court noted that for the period 1974 through 1977 Boynton made unmatched contributions of $1,121,066.16 and that for the same period the partnership's $1,191,186.78 losses were all allocated to Boynton. Boynton has not yet sought to enforce his right of contribution against Plimpton regarding the loans made; Plimpton feels he was under no obligation to repay any of the partnership losses.

[7]Section 704 was amended by the Tax Reform Act of 1976, Pub.L.No.94-455, 90 Stat. 1520 (codified in scattered sections of 26 U.S.C.) but this amendment does not apply to the 1974 taxable year at issue. All references will be to the original IRC §704 unless otherwise indicated.

the 1974 amendment to the partnership provision did not *in fact* incease his "distributive share" of the partnership's profits and losses, the loss allocation was ineffective and Boynton could claim on his tax return only 50% of the partnership's losses. IRC §704(a) provides that the formula selected by the partners for actually dividing the profits and losses will determine their distributive shares.[8] The Tax Court concluded that the amended partnership agreement lacked economic substance since it had no effect on the original agreement's overall distribution of profits and losses and had effect only for federal tax purposes.[9]

On appeal Boynton argues that the loss allocation had economic justification since without his funds the partnership could not have continued operations. In other words, the economic circumstance necessary to justify the allocation of all of the taxable losses to Boynton was the reasonably high probability that he would bear the economic detriment of any losses in light of Plimpton's inability to contribute financially. Moreover, Boynton contends that the Tax Court ignored

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[8]IRC §704(a) states:

> A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

[9]Amended Partnership Agreement, Article IV-4 Accounting

> §4.44 The different allocation of profits and losses for tax purposes shall not affect or be considered as a part of the partnership accounting, the sole purpose of such differing treatment being to allocate losses for tax purposes to the person who will suffer such losses in the event the partnership does not later make sufficient income to meet its obligations.

the economic reality that he was the sole contributor by giving undue weight to Plimpton's business resiliency; the Tax Court emphasized Boynton's rights to recover against Plimpton should the latter's separate businesses recover.

[1-3] It is axiomatic that only the partner who actually incurs a loss will be allowed a deduction for that loss. *See New Colonial Ice Co. v. Helvering*, 292 U.S. 435, 440, 54 S.Ct. 788, 790, 78 L.Ed. 1348 (1934). Nor is there any dispute that if Boynton had contributed all of the partnership capital then the allocation of all of the partnership's taxable losses to him as the sole contributing partner would have been proper to reflect the fact that he bore the entire economic burden of any loss. *See, e.g., Harrell v. Commissioner*, 37 T.C.M. 911, 916 (CCH Dec. 35,201(M)) (1978); Treas.Reg. §1.704-1(b)(2), Example 5 (1964). Boynton concedes that, if he had contributed money solely in exchange for tax benefits and Plimpton were able to satisfy his obligations regarding contributions, the allocation would lack economic reality and would be a sham. Transactions that have no economic effect other than the creation of income tax losses are shams for tax purposes and will not be recognized. *See Knetsch v. United States*, 364 U.S. 316, 81 S.Ct. 132, 5 L.Ed.2d 128 (1960); *Gregory v. Helvering*, 293 U.S. 465, 55 S.Ct. 266, 79 L.Ed. 596 (1935).

One of the primary issues in this case is what standard should be applied to the loss allocation involved to ascertain whether it was bona fide under IRC §704.

Under IRC §702(a)(9)[10] taxable losses, so-called bottom line losses, are determined by reference to a partner's distributive share of the profits and losses as they were actually divided. Prior to the amendment of Section 704 it was unclear whether bottom line loss allocations were subject to IRC §704(b)(2)'s tax evasion test which provided that, if the principal purpose of any allocation provision was the avoidance or evasion of any tax, the partners' agreement regarding their loss ratios would be ignored and the actual distributive shares under Section 702(a)(9) would determine the taxable loss.[11] Under the regulations, the tax evasion/avoidance test essentially evolved into a substantial economic effect

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[10]IRC §702(a)(9) states:

> (a) General rule.—In determining his income tax, each partner shall take into account separately his distributive share of the partnership's—
>
> (9) taxable income or loss, exclusive of items requiring separate computation under other paragraphs of this subsection.

[11]IRC §704(b)(2), the only statutory limitation on Section 704(a) states:

> (b) Distributive share determined by income or loss ratio—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—
>
> * * * * * *
>
> (2) the principal purpose of any provision in the partnership agreement with respect to the partner's

test. *See* Treas. Reg. §1.704-1(b)(2).[12] *See generally* Kamin, *Partnership Income and Loss Allocations Before and After the Tax Reform Act of 1976*, 30 Tax Lawyer 667, 672 (1977); McKee, *Partnership Allocations in Real Estate Ventures: Crane, Kresser and Orrisch*, 30 Tax Law Rev. 1, 15-18 (1974) [McKee I].

(Footnote 11 Continued)

distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle.

Treas.Reg. §1.704-1(b)(1) (1964) states in part:

... [T]he manner in which the net profit or loss (computed after excluding any items subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss as described in section 702(a)(9).

[12]Treas.Reg. §1.704-1(b)(2) provides in part that:

[T]he [partnership] provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect," that is, *whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences;* whether related items of income, gain, loss, deduction, or credit from the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. (Emphasis added).

[4] However, the Commissioner does not argue that the statutory tax avoidance test under IRC §704(b)(2) applied to Boynton's deduction; in fact, the Commissioner conceded in *Holladay* that Section 704(b)(2) did not apply to bottom line losses.[13] Rather the Commissioner argues that, when the allocation of all partnership losses to one partner does not affect the overall distribution of profits and losses, that allocation lacks economic substance under Section 704(a). In other words, the Commissioner looked past the form of the allocation to its substance in concluding that Boynton's loans could not justify his deduction of *all* of the partnership's losses in 1974. We agree.

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[13]Allocations of special items such as depreciation, capital gains and dividends were clearly covered by IRC §704(b)(2). *See* IRC §§702(a)(1)-(a)(8). The main reason Congress amended Section 704 was to make it clear that bottom line losses were covered by Section 704(b)(2) and to formally recognize as a statutory provision the substantial economic effect test as stated by the Regulations and the case law. *See* McKee, Nelson & Whitmire, *Federal Taxation of Partnerships and Partners* [McKee II] §10.01[2] (1977). The revised Section 704(b)(2) reads as follows:

> (b) Determination of distributive share.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—
>
> * * * * * * *
>
> (2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect.

Boynton chose to characterize his excess advances in 1974 as loans, not contributions; accordingly, if the loans were not repaid, Boynton could claim a deduction under the bad debt provision of the IRC the year the loans became worthless. He conceded that he expected repayment of his loan when it was initially made in 1974. The taxpayer is bound by the tax consequences of his choice in characterizing the excess advances as loans. *See Dixie Finance Co. v. United States*, 474 F.2d 501 (5th Cir. 1973). The Tax Court's factual finding that Boynton's rights of recovery against Plimpton were not hopeless is supported by the record. Boynton seeks to have this Court treat Plimpton as a bankrupt yet Boynton made no effort to treat Plimpton as less than a full partner because of the possibility that Plimpton would recover from his economic reversals.[14] Plimpton's separate business did recover after the Environmental Protection Agency reversed its adverse ruling; moreover, Plimpton's October 10, 1973, financial statement reflected a net worth in excess of $900,000.

We are not convinced that Plimpton's unsupported assertion that he could not be held liable for the partnership's liabilities is sufficient to justify the loss allocation provision. The amended partnership agreement did not relieve Plimpton of his obligation to bear half of the economic losses that might be realized upon the sale of the grove or liquidation of the partnership. *See* Appendix, Article §4.11. Accordingly, Boynton had a right of contribution against Plimpton under Florida

---

[14]Boynton claims that in 1974 he did not think that he would *ever* recover his cash advances from Plimpton and that the most he hoped for was that the land would increase in value to allow him to recoup some of his losses upon its sale.

Partnership law that was viable in 1974. *See* Fla.Stat.Ann. §620.645(1) (1972). Although the events after 1974 do not affect the incidence of taxation at issue, it is interesting to note that Boynton and Plimpton equally divided the money from the citrus pool, the only funds ever recovered from the partnership.

Moreover, Boynton's 1974 loan was $123,474, yet he claimed $366,296 otherwise allocable to Plimpton in addition to the $366,296 loss deduction to which he was entitled. In other words, Boynton was the sole contributor only *after* the funds borrowed by both partners were expended yet he claimed *all* of the partnership losses on his individual return. Because the partnership's overall distribution of profits and losses remained unchanged by the amended loss allocation provision, we conclude that the allocation of all of the partnership losses to Boynton lacked economic effect. *See Sellers v. Commissioner*, 617 F.2d 1042, 1043, 1044 (4th Cir. 1980); *Kresser v. Commissioner*, 54 T.C. 1621 (1970). In *Kresser* the Tax Court stated than an allocation of partnership bottom line losses under IRC §704(a) is bona fide only if that allocation accurately reflects the economic basis upon which the partners agreed to share the profits and losses. *Id.* at 1630-31.[15] If Boynton had instead received loss allocations in proportion to his excess advances as opposed to loss allocations for the partnership's total losses claimed in 1974, the amended agreement may have been sustained. *See Miller v. Commissioner*, 285 F.2d 843 (10th Cir. 1960). The amended partnership agreement did not in fact increase Boynton's distributive share or decrease Plimpton's distributive

[15] *Kresser's* holding that the transaction involved therein lacked a substantial economic effect did not rely on IRC §704(b)(2).

APPENDIX

The Amended Partnership Agreement provides in part:

WHEREAS, the partnership is in need of cash funds to meet its obligations; and

WHEREAS, Boynton is willing to supply such funds by way of loans to the partnership, but only if he receives the benefit of all partnership losses, until such time as all funds have been returned; and

* * * * * *

ARTICLE IV-1 PROFITS AND LOSSES

4.11 Except as otherwise provided for determining each partner's share of the partnership income and loss for purposes of the federal income tax, all profits and losses of the partnership shall be allocated equally between the two partners.

4.12 Notwithstanding the provisions of Section 4.11 hereof, the partners recognize that Boynton will be required to make cash available to the partnership from time to time until such time as it shows a positive cash flow; and that Boynton is the individual to whom the institutional lenders will look for a repayment of the partnership loans if they cannot be satisfied out of partnership funds.

Because of the foregoing, the allocation between them of profits and losses for tax purposes, but not for the purpose of determining their share of distributions

(which shall be governed by Section 4.11 hereof), shall be as follows:

(a) The taxable income and/or loss of the partnership under the governing provisions of the Internal Revenue Code of 1954 shall be determined; then

(b) As long as there is a credit balance in either partner's loan account, all losses shall be allocated to such partner;

(c) Gains from the sale of any asset with respect to which the partnership has claimed depreciation, shall be allocated to the partner who received the tax benefit from such depreciation to the extent of the lesser of such depreciation or the amount of gain; and

(d) All other income, gains, profits, and for any year in which there is no balance in either partner's loan account as of the end of such year, losses, shall be allocated in accordance with the ratio for sharing profits and losses.

ARTICLE IV-2 CAPITAL AND LOANS

4.21 The partners may from time to time make advances to the partnership. To the extent such advances are equal, the amounts thereof shall be credited to each partner's capital account.

4.22 The amounts by which the total net advances made by one partner exceed the total net advances made by the other partner, shall be treated as loans to the partnership by the partner making such excess advances; and shall bear interest at the rate of nine

(9%) percent per annum. Such interest shall be paid as funds are available.

ARTICLE IV-3 DISTRIBUTIONS

4.31 From time to time, the partnership shall distribute to its partners, in proportion to their interest in partnership profits and losses, all of its available cash. All such distributions shall be made to and among the partners and divided among them on the basis of their respective interests in the profits of the partnership, and no cash distributions shall be made to any partner except in repayment of loans and/or interest thereon, unless a proportionate amount, according to their respective interests in the partnership profits, is distributed to the other partner.

* * * * * *

4.33 No cash shall be considered available until all amounts advanced by a partner and treated as loans have been repaid; it being understood that all advances treated as loans and the interest thereon are to be repaid before any cash distributions are made to the other partner.

ARTICLE IV-4 ACCOUNTING

4.41 The partnership shall maintain a capital, loan, drawing, and income account for each partner.

4.42 The income account of each partner shall be debited or credited with such partner's share of the profits and losses allocated in the manner specified in section 4.11 hereof.

4.43 All advances by the partners to the partnership shall be treated in the manner specified in Article IV-2 hereof. All distributions to a partner shall be treated as repayments of a partner's loans to the extent thereof, and any excess shall be charged to such partner's drawing account.

4.44 The different allocations of profits and losses for tax purposes *shall not effect* (sic) [emphasis added] or be considered as a part of the partnership accounting, the sole purpose of such differing treatment being to allocate losses for tax purposes to the person who will suffer such losses in the event the partnership does not later make sufficient income to meet its obligations.

Appendix C

[FILED AUG 24 1981]

IN THE UNITED STATES COURT OF APPEALS
FOR THE FIFTH CIRCUIT

UNIT B

NO. 80-5069

JOE T. BOYNTON and HELEN J. BOYNTON,
Petitioners-Appellants,

versus

COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

Appeal from the Decision of the Tax Court of
the United States

ON PETITION FOR REHEARING
(August 24, 1981)

Before HILL and FRANK M. JOHNSON, Circuit Judges,
CHARLES R. SCOTT, District Judge

PER CURIAM:

IT IS ORDERED that the petition for rehearing filed in the above entitled and numbered cause be and the same is hereby DENIED.

ENTERED FOR THE COURT:

[Illegible]
United States Circuit Judge

CLERK'S NOTE:
SEE RULE 41 FRAP AND
LOCAL RULE 17 FOR STAY
OF THE MANDATE

Appendix D

Sections 704(a) and 704(b) of the Internal Revenue Code of 1954 (as of December 31, 1974)

"SEC. 704—PARTNER'S DISTRIBUTIVE SHARE.

(a) EFFECT OF PARTNERSHIP AGREEMENT—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this section, be determined by the partnership agreement.

(b) DISTRIBUTIVE SHARE DETERMINED BY INCOME OR LOSS RATIO—A partner's distributive share of any item of income, gain, loss, deduction, or credit shall be determined in accordance with his distributive share of taxable income or loss of the partnership, as described in section 702(a)(9), for the taxable year, if—

(1) the partnership agreement does not provide as to the partner's distributive share of such item, or

(2) the principal purpose of any provision in the partnership agreement with respect to the partner's distributive share of such item is the avoidance or evasion of any tax imposed by this subtitle."

Sections 704(a) and 704(b) of the Internal Revenue Code of 1954 (as of October 22, 1981)

"SEC. 704. PARTNER'S DISTRIBUTIVE SHARE.

(a) Effect of Partnership Agreement.—A partner's distributive share of income, gain, loss, deduction, or credit shall, except as otherwise provided in this chapter, be determined by the partnership agreement.

(b) Determination of Distributive Share.—A partner's distributive share of income, gain, loss, deduction, or credit (or item thereof) shall be determined in accordance with the partner's interest in the partnership (determined by taking into account all facts and circumstances), if—

(1) the partnership agreement does not provide as to the partner's distributive share of income, gain, loss, deduction, or credit (or item thereof), or

(2) the allocation to a partner under the agreement of income, gain, loss, deduction, or credit (or item thereof) does not have substantial economic effect."

Regulations under Sections 704(a) and 704(b) of the Internal Revenue Code of 1954

§1.704 Statutory provisions; partner's distributive share. [Sec. 704, IRC]

§1.704-1 (T.D. 6175, filed 5-23-56; republished in T.D. 6500, filed 11-25-60; amended by T.D. 6771, filed 11-19-64). Partner's distributive share. (a) *Effect of partnership agreement.* A partner's distributive share of any item or class of items of income, gain, loss, deduction, or credit of the partnership shall be determined by the partnership agreement, unless otherwise provided by section 704 and paragraphs (b) through (e) of this section. For definition of partnership agreement see section 761(c).

(b) *Distributive share determined by income or loss ratio.* (1) If the partnership agreement makes no

specific provision for the manner of sharing one or more items or classes of items, a partner's distributive share of such items shall be determined in accordance with the provisions of the partnership agreement for the division of the general profits or losses (that is, the taxable income or loss of the partnership as described in section 702(a)(9)). In applying this rule, the manner in which the net profit or loss (computed after excluding any item subject to a recognized special allocation) is actually credited on the partnership books to the accounts of the partners will generally determine each partner's share of taxable income or loss as described in section 702(a)(9) .

(2) If the principal purpose of any provision in the partnership agreement determining a partner's distributive share of a particular item is to avoid or evade the Federal income tax, the provision shall be disregarded and the partners' distributive shares of that item shall be determined in accordance with the ratio in which the partners divide the general profits or losses of the partnership (as described in section 702(a)(9)). In determining whether the principal purpose of any provision in the partnership agreement for a special allocation is the avoidance or evasion of Federal income tax, the provision must be considered in relation to all the surrounding facts and circumstances. Among the relevant circumstances are the following: Whether the partnership or a partner individually has a business purpose for the allocation; whether the allocation has "substantial economic effect", that is, whether the allocation may actually affect the dollar amount of the partners' shares of the total partnership income or loss independently of tax consequences; whether related items of income, gain, loss, deduction, or credit from

the same source are subject to the same allocation; whether the allocation was made without recognition of normal business factors and only after the amount of the specially allocated item could reasonably be estimated; the duration of the allocation; and the overall tax consequences of the allocation. The application of the provisions of this subparagraph may be illustrated by the following examples:

Example (1). The provisions of a partnership agreement for a year in which the partnership incurs losses on the sale of depreciable property used in the trade or business are amended to allocate such losses to one partner who has no such gains individually. An equivalent amount of partnership loss or deduction of a different character is allocated to other partners who individually have gains from the sale of depreciable property used in the trade or business. Since the purpose and effect of this allocation is solely to reduce the taxes of certain partners without actually affecting their shares of partnership income, such allocation will not be recognized. Under section 704(b)(2), those items will be allocated to all the partners in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (2). The provisions of a partnership agreement allocate to a partner who is a resident of a foreign country a percentage of the profit derived from operations conducted by him within such country, which percentage is greater than his distributive share of partnership income generally. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion.

Example (3). Rather than impair the credit standing of the AB partnership by a distribution, the partners agree to invest surplus partnership funds in an equal dollar amount of municipal bonds and corporate stock. The partners further agree that A is to receive all the interest income and gain or loss from tax-exempt bonds and B is to receive all the dividend income and gain or loss from corporate stock. Such allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose was tax avoidance or evasion. On the other hand, under an agreement with respect to partnership CD, it is provided that C's distributive share of income shall be the first $10,000 of tax-exempt income and D's distributive share of income shall be the first $10,000 of dividend income, the balances to be divided equally. Since the principal purpose of this provision is to allocate tax-exempt interest to C, who is in a higher income tax bracket than D, it will be disregarded. Each partner's distributive share of such interest and dividends will then be allocated in accordance with the provisions of the partnership agreement for sharing partnership income or loss generally.

Example (4). KL is a brokerage partnership with assets consisting of securities with a basis of $20,000 and a value of $50,000. M makes a $25,000 cash contribution to the partnership in order to become an equal partner. Subsequently, when the value of the securities has appreciated to $74,000, they are sold. Of the $54,000 taxable gain on the sale of the securities, $24,000 (appreciation in value occurring after M became a partner) is allocated in equal shares to K, L, and M, in accordance with the ratio for sharing profits and losses generally. The $30,000 balance is allocated to K and L in the

profit and loss ratio existing before M became a partner. This latter allocation attributes to K and L the appreciation in value of the securities occurring before M became a partner, even though the cash proceeds are a partnership asset in which all three partners share equally. This allocation has substantial economic effect and will be recognized in the absence of other circumstances showing that the principal purpose of the allocation was tax avoidance or evasion.

Example (5). G and H, each of whom is engaged as a sole proprietor in the business of developing and marketing electronic devices, enter into a partnership agreement to develop and market electronic devices. H contributes $2,500 cash and agrees to devote his full-time services to the partnership. G contributes $100,000 cash and agrees to obtain a loan for the partnership of any additional capital needed. The partnership agreement provides that the full amount of any research and experimental expenditures and any interest on partnership loans are to be charged to G. It also provides that G's distributive share is to be 90 percent of partnership income or loss computed without reduction by such research and experimental expenditures and such interest, until all loans have been repaid and G has received through his 90 percent share of income an amount equal to the full amount of such research and experimental expenditures, of such interest, and his share of any partnership operating losses. During this time H's distributive share will be 10 percent. Thereafter, G and H will share profits and losses equally. Since all of the research and experimental expenditures and interest specially allocated to G are in fact borne by G, the allocation will be recognized in the absence of other circumstances showing that its principal purpose was tax avoidance or evasion.

CERTIFICATE OF SERVICE

It is hereby certified that service of the foregoing Petition for Certiorari, has this 22nd day of October, 1981 been made on the counsel for the Commissioner of the Internal Revenue Service and the office of the Solicitor General of the United States, by depositing three copies thereof to each such party, first class postage prepaid to the United States mail, addressed as follows:

Gilbert E. Andrews, Chief
Appellate Section, Tax Division
United States Department of Justice
Washington, D.C. 20530

Solicitor General
Department of Justice
Washington, D.C. 20530

Robert O. Rogers
Attorney for Petitioners

STATEMENT OF MAILING

Pursuant to Rule 28.2 of the Rules of the Supreme Court of the United States, the undersigned member of the Bar, to the best of his knowledge, declares that the foregoing Petition for Certiorari was timely filed on October 22nd, 1981, by depositing the same with the United States post office, Palm Beach, Florida, first-class postage prepaid and properly addressed to the Clerk of this Court.

Robert O. Rogers
Attorney for Petitioners

STATE OF FLORIDA
COUNTY OF PALM BEACH

The foregoing Statement of Mailing was acknowledged before me this 22nd day of October, 1981, by Robert O. Rogers.

Opposition

Office - Supreme Court, U.S.
FILED
DEC 1 1981
CLERK

No. 81-818

In the Supreme Court of the United States

OCTOBER TERM, 1981

JOE T. BOYNTON AND
HELEN J. BOYNTON, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

REX E. LEE
Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 633-2217

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MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

In this federal income tax case, petitioners [1] seek review of the decision of the court of appeals [2] holding that the losses of a partnership could not be al-

[1] References to "petitioner" are to Joe T. Boynton. Helen J. Boynton is a party solely because she filed a joint income tax return with her husband for the years in issue (Pet. App. B-3 n.1).

[2] The opinion of the court of appeals is reported at 649 F.2d 1168.

located to one partner for tax purposes, where the profits and losses of that partnership were equally divided for all other purposes.

The relevant facts may be summarized as follows: Petitioner and a party named Plimpton formed a partnership, the object of which was to purchase and operate citrus groves. The original partnership agreement provided that they would share profits and losses equally (Pet. App. B-4 to B-5). The groves which were purchased did not generate sufficient cash to support the partnership operations and it became obvious that the partnership needed additional operating funds (Pet. App. B-5). Plimpton was unable to provide his share of the additional funds because of reverses in other business ventures (Pet. App. B-5). Petitioner then agreed to advance funds to the partnership to keep it operating. These advances were in the form of loans to the partnership, rather than capital contributions (Pet. App. B-5 to B-6). Petitioner and Plimpton thereupon amended the partnership agreement so that it provided that if one partner made advances in excess of the other partner, the amount of the excess advances would be treated as a loan to the partnership. Only one partner at any given time could have a credit balance in his loan account. The agreement further provided that all partnership losses were to be allocated to the partner with the credit balance in his loan account, for tax purposes only, until the loans were repaid (Pet. App. B-6). For all other purposes, however, the provision of the partnership agreement stating that profits and losses would be shared equally remained in effect (Pet. App. B-6). Based upon his loans of $123,474.81 to the partnership, petitioner

sought in 1974 to deduct all the partnership's losses, totalling $732,592 (Pet. App. B-7).[3] On audit, the Commissioner disallowed half his claimed losses on the ground that he was only a 50% partner. The Tax Court upheld the Commissioner's determination and the court of appeals affirmed (Pet. App. B-1 to B-19).

1. The decision below correctly rejected petitioner's attempted allocation to himself of all the tax losses of his partnership because it lacked economic substance. Under Section 702(a)(9) of the Internal Revenue Code of 1954 (26 U.S.C. (1970 ed.)), each partner, in determining his federal income tax, is required to take into account his "distributive share" of the partnership's "taxable income or loss." In making this determination, the Tax Court correctly observed that allocations of partnership income and losses "must be bona fide in the sense that they are genuinely in accord with the actual division of profits and losses inter sese which the partners have in fact agreed upon among themselves" (Pet. App. A-20). Accord: *Kresser* v. *Commissioner*, 54 T.C. 1621, 1630-1631 (1970); *Holladay* v. *Commissioner*, 72 T.C. 571, 587 (1979), aff'd, 649 F.2d 1176 (5th Cir. 1981).

Here, the partnership agreements, as amended, continued to provide that all partnership profits and losses were to be shared equally by the two partners (Pet. App. A-3, A-9, B-16). Accordingly, the courts below correctly ruled that under that partnership agreement, the allocation of all tax losses to petitioner lacked economic substance (Pet. App. A-24, B-13). As this Court ruled in *New Colonial Ice Co.* v. *Helvering*, 292 U.S. 435, 440-441 (1934), only the

[3] Those large deductions caused petitioner to claim loss carrybacks for 1971 through 1973 (Pet. App. B-7).

taxpayer who actually incurs a loss will be allowed a tax deduction for that loss. Because the partnership's economic losses were to be shared equally between the partners, the tax benefits of such losses cannot be allocated to petitioner alone.[4]

2. Petitioner argues (Pet. 5-7) that the likelihood that he would bear the economic detriment of partnership losses was so great that he should be allowed to deduct all partnership losses, and that the court of appeals erred by failing to consider all the facts and circumstances of the case.

But, as the court of appeals noted (Pet. App. B-14 to B-15), the record supported the Tax Court's factual finding that petitioner's rights of recovery against Plimpton were not hopeless. Further, the court of appeals observed that Plimpton's assertion that he could not be held liable for the partnership's liabilities was contrary to applicable Florida law, and was insufficient to justify the loss allocation provision.

Moreover, contrary to petitioner's claim (Pet. 5), it is not at all certain that the court of appeals applied an "objective" standard, as opposed to a "facts and circumstances" test. In accordance with this Court's decision in *Commissioner* v. *National Alfalfa Dehydrating & Milling Co.*, 417 U.S. 134, 149 (1974), the court of appeals took the transaction as the participants designed it. Since a taxpayer is bound by the form in which he casts his transaction, petitioner cannot recast his loan to a contribution to partner-

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[4] The court of appeals here also noted (Pet. App. B-14 to B-15) that petitioner's partner remained liable to repay half the loans petitioner made to the partnership, and that if petitioner's loans to the partnership were not repaid he would be entitled to a bad debt deduction in the year the debt became worthless.

ship capital for that year simply for the purpose of increasing his distributive share of partnership losses.

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

REX E. LEE
Solicitor General

DECEMBER 1981

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